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PROGRAMME OF WORK OF THE INTERGOVERNMENTAL WORKING GROUP OF EXPERTS ON INTERNATIONAL STANDARDS OF ACCOUNTING AND REPORTING: ACCOUNTING ISSUES ARISING DURING PRIVATIZATION

Accounting problems arising during privatization in Poland

Report of the Secretary-General

SUMMARY

Following the political changes in 1990, the new Government of Poland is seeking to privatize much of its economy to improve efficiency and effectiveness. Gross domestic product declined 12 per cent in 1990 and another 8 per cent in 1991, with the loss of many of its traditional foreign markets. Small- and medium-sized enterprises are rapidly being sold, rented or leased to entrepreneurs. Large enterprises are being restructured and sold in public share offerings to domestic and foreign investors or are being distributed to the citizens through an innovative coupon scheme. As is the case with other countries in transition to a market economy, there is a shortage of domestic capital for investment in business enterprises. Restrictions on foreign investment and political instability have inhibited large inflows of new capital into Poland, but this should change with

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legislation recently passed by Parliament. The new Securities Exchange has limited trading activity, but it is developing. Providing adequate financial information for investors and managers in a market economy is a problem for all countries whose accounting systems served the needs of central planners. Poland is developing an appropriate accounting system and is training educators and practicing accountants. The Association of Professional Accountants is in its formative stage. Valuation of enterprise assets and liabilities is difficult in this environment because historical information is of little use in predicting future results of operations. Substantial inflation has further complicated the valuation process.

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INTRODUCTION

I. FACTORS INFLUENCING THE SELECTION OF PRIVATIZATION METHODS

1. The privatization process in Poland has been driven by two main sets of goals: economic and socio-political (Borowiecki, 1991, pp. 100-103), with economic goals commanding the most immediate attention. Long-term economic goals are aimed at demonopolizing and restructuring the economy, and at creating mechanisms for encouraging inflows of capital, so as to bring about competition and promote efficiency and effectiveness throughout the economy. In the short run, it is hoped that the privatization programme will have anti-inflationary - and thereby stabilizing - effects.

A. Improving economic effectiveness

2. The main, and most compelling, economic goal, is to increase the effectiveness of enterprises and the effectiveness of the economy as a whole, so as to expand national income. The statistics for the first four months of 1991, released by the Central Statistics Office at the end of May (Rzeczpospolita, 25-26 May 1991), reveal a budget deficit of about 9.6 billion zlotys, or over US$ 800,000, mainly due to the poor financial results of State enterprises, which were supposed to provide over 90 per cent of State's current revenues. Only 60 per cent of the more than 19,000 enterprises were in a break-even or profitable condition, but it is not clear whether, even though not in a loss position, they were able to pay dividends 1/ and taxes. For many enterprises, the most immediate cause of their financial difficulties has been the collapse of the Soviet markets. Others have been affected by the loss of military business. Because decision-making power is shared between management, the workers' councils, and the Solidarity Union, financial difficulties have been exacerbated by a general reluctance to lay off workers, which has led to the stockpiling of unsalable goods, maintenance of excessive payroll levels, and, in certain cases, mounting interest, as loans were taken out to cover operating expenses.

3. Privatizing the enterprises would bring them under the Commercial Code, giving top management a much freer hand since a workers' council would be replaced with a supervisory board. It is also generally assumed that managers would give first priority to improving their company's economic and financial results, rather than to steadily increasing payrolls which is the highest priority of the workers' councils (Kotowicz, 1991). Workers have also generally supported privatization, primarily because of the potential for wage increases. This is because commercial companies are not subject to the prohibitively high taxes on increases over a defined norm in average pay.

B. Developing the capital market

4. A secondary economic goal is developing the capital market so as to obtain at least three main benefits: structural change in the economy, brought about by capital investment in sectors heavily favoured by domestic demand; inflows of foreign capital pursuing perceived profitable opportunities; and greater access to international capital markets helping to integrate the domestic and international communities. This means, of course, that conditions for developing the capital market have to be compatible with encouraging foreign investment.

5. While domestic financial markets are being strengthened, market forces and competition are being stimulated, and enterprise performance is being improved, some of the burdens on the State treasury will be relieved through proceeds from the sale or lease of State property. So, until private and privatized enterprises can supply the necessary inflows of tax revenues, the State will have to depend on realizing its assets through sales or leases in order to help finance its operations.

C. Socio-political goals

6. The privatization process has various, and interconnected, social and political objectives. Building a democratic way of life requires the stability which comes with a community of shared interests. This could be furthered by limiting State intervention in economic processes and increasing worker motivation to achieve personal goals by taking an active part in economic affairs. The various privatization techniques described in this study are heavily geared to encouraging popular participation by way of, for example, management/employee buyouts, leasing, receiving equity in investment groups through privatization coupons, and buying shares in largely privatized enterprises.

D. Availability of local capital

7. Poland's plans to transfer most of its equity in some 8,000 State enterprises to private ownership within the next five years could run into financing problems because of the low level of available domestic capital and the present restrictions on foreign investments.

8. The value of State property to be privatized is estimated at about $40 billion. The average Polish citizen has very little experience with, or understanding of, the investment process and earns about $150 per month. Assuming that the citizenry would be interested in investing 10 per cent of its approximately $10 billion in domestic savings - that is to say $1 billion, there would be a shortfall of $39 billion. Under the present law, only $4 billion of this amount could come from abroad, because foreign acquisitions of shares are restricted to 10 per cent. So, there is a significant gap of $35 billion in the financing plans (Sopocek, 1990).

9. Measures aimed at filling the void for capital started getting under way in the first half of 1991 and involve at least three mechanisms: easing the financial strain on small investors by providing for leasing, rather than purchasing, property and permitting purchases on an instalment basis rather than a cash-only approach; developing a scheme for creating investment funds, operated by Western experts, in which adult Polish citizens would receive participation certificates through the issuance of free privatization coupons, as described below; and revising the provisions for foreign investment.

E. Foreign investment

10. There are three basic ways for foreigners to carry out business activities in Poland (KPMG, 1991, p. 9): through investment in a company incorporated with limited liability, or in a joint stock company, created in accordance with Polish laws, 2/ or by establishing a representative office of a foreign company. Under the present law, the first two methods require approval by the Foreign Investment Agency (FIA), unless they have to do with forming a bank with foreign investors or establishing a bank representative office, which would require approval by the President of the National Bank of Poland (NBP) in agreement with the Minister of Finance. Establishing a representative office not connected with banking requires approval by the Ministry of Foreign Economic Relations.

11. By mid 1991, nearly 4,000 foreign investment licences had been issued, mostly for small businesses, including about 2,500 for joint ventures. As of the end of 1990, foreign investment in Poland totalled just under $200 million (Bobinski, 1991a) with about 80 per cent related to joint ventures in operation. This relatively small sum reflects investor concerns over the high risk associated with political and economic instability and the controls over currency exchange and profit repatriation.

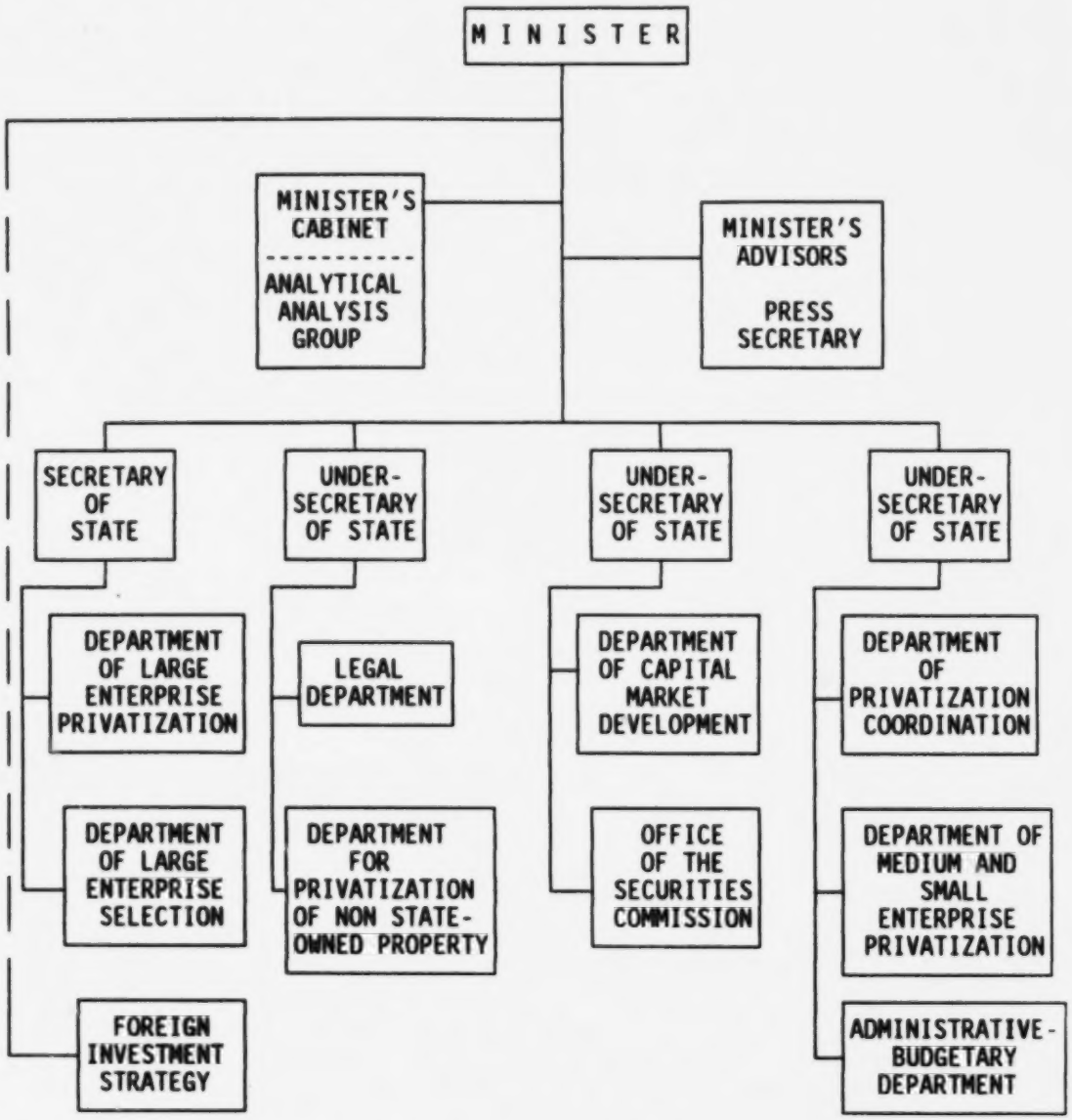
12. A fourth way for foreigners to invest in Poland would be to acquire shares in privatized companies. However, the Privatization Act (13 July 1990) puts a low ceiling on foreign participation by requiring the approval of the President of the Foreign Investment Agency for foreigners to acquire shares whose par value exceeds 10 per cent of the share capital.

13. A new draft investment law, approved by parliament in mid June 1991 (Bobinski, 1991a), aims to attract more foreign investment by changing certain administrative arrangements and improving various conditions. The Foreign Investment Agency would be replaced by an investment promotion agency. The 10 per cent limit on acquisition of privatization shares by foreigners would be lifted, as would many of the current requirements for licences for investment purposes, and future licence requirements would come under the jurisdiction of the Ministry for Ownership Transformations.

F. Existing capital markets

14. Review of Poland's capital markets, which consist of the newly created Securities Exchange and the banking system, brings together the two main agencies in privatization's institutional arrangements: the Ministry of Finance, and the Ministry for Ownership Transformations. The former is responsible for privatization of the banking and insurance sectors and works closely with the independent president of the Polish National Bank (NBP) who sets the guidelines for banking policies. The Ministry for Ownership Transformations is responsible for privatizing the rest of the economy and one of its organizational units, as illustrated in figure 1, the Securities Commission, is the oversight body for the Securities Exchange.

Figure 1. Organization structure of the Ministry of Ownership Transformations



Source: Centrum Prywatyzacji, Vademecum Prywatyzacji, Warsaw, 1991, p. 211.

G. The Securities Exchange 3/

15. The Securities Exchange, which was inaugurated on 16 April 1991, is legally organized as a company solely owned by the State Treasury. Initially, only the five large enterprises privatized through public share offerings in November and December 1990 were listed. Because of low volume trading, the exchange held sessions only once a week, on Tuesdays, lasting three hours. Following the sixth privatization, in May 1991, of the Swarzędz furniture factory, a second weekly session will likely be added. Operations are modelled on those of the French regional bourse in Lyon which is order-driven, or dependent on orders, rather than price-driven, with continually changing prices, as in New York, for example. Until they are licensed, brokers are prohibited from providing investment advice to the public. Consequently, the press assumed a very influential role in stimulating investment interest, which has grown from a turnover of 40 million zlotys (then worth just over $4,000) at the first session of the exchange to just over one and a half billion (about $158,000), or almost 40 times more, some four weeks later.

H. The banking system

16. Poland started the reform of its banking system at the beginning of 1989 so as to increase both the number of banks and the range of services they could offer. Three years later, the number of different banks had grown to 74, many of them with branches across the country (KPMG, 1991, p. 53). The nation's monetary policy guidelines, which include currency and credit policies, are established by the President of the National Bank of Poland.

17. The banking system was first enlisted as a substitute, or supplementary, capital market mechanism, in November 1990 when shares in five large enterprises were offered for sale by the State Treasury. Some 200 banking outlets across the country were involved in this process - the two lead banks being the Polska Kasa Opieki, SA, and the Bank Slaski, assisted by the Wielkopolski Bank Kredytowy and the Bank Gdanski.

18. It was apparent during the first few hours after the banks opened for business that they were not equipped to handle the new type of activity. According to public complaints (Żychowicz, 1990), there were not enough windows open or personnel available, the number of copies of the prospectuses available was insufficient, people seeking information had to wait in the same lines as those seeking to subscribe, and the subscription process could take up to half an hour per client. Part of the slow tempo had to do with the means of payment, since a 20 per cent discount off share prices was given if payment was made with government bonds. This meant that the bank clerk had to determine the current market value of each bond offered, either by reference to a schedule or, if one were not available, by making a telephone call for assistance. Only about 11 per cent of the available shares were subscribed for during the first two days because of the slow service, and the subscription period had to be extended in December.

19. One of the privatizing companies, Exbud, displayed unusual initiative in getting around the administrative tangle (Żychowicz, 1990). It set up information centres in all 11 of its plants so that employees could both learn about the conditions for buying its shares and leave instructions for third persons to buy shares on their behalf. Not surprisingly, Exbud shares were the first to sell out.

20. It was six months before the next public share offer took place: that of the Swarzędz furniture factory in May 1991. Once again, the banking system was selected as the primary distribution channel, and it was evident from the speed with which the process took place that much had been learned from the earlier experiences. All available small lots (packets) of shares were subscribed for within the first 40 minutes.

II. PRIVATIZATION STRATEGIES USED IN POLAND

21. Poland's basic strategy to facilitate the entire privatization process and promote the selection of appropriate techniques is to sort State enterprises by size - that is, to use different methods and channels depending on whether enterprises are classified as large, medium, or small. A State enterprise leaves the State sector through one of two possible processes: transformation or liquidation. Transformation involves the legal reorganization of the enterprise into a private company without any winding-up stage in the process. Liquidation involves the winding-up of the enterprise before the State assets come under private ownership. The Government's 1991 programme (Monitor Polski, No. 13) is aimed at making conditions for speeding up privatization over the next five years favourable enough for Poland to achieve a level of private-sector participation in the economy comparable with that of the European Community.

A. Large enterprises

22. The transformation process is usually associated with large enterprises, and three main privatization techniques are contemplated for the 500 or so State enterprises classified as large. They are: sale by public share offer; private sale; and partial equity transfers by the State Treasury to investment groups known as National Wealth Management Funds (NWMFs).

23. Shares in the first five enterprises were offered for public sale at the end of November 1990, as described below, and a further three such offerings took place in the summer of 1991. The total should be brought up to 20 by the end of 1991 and will include between six and nine of the largest State enterprises in the country. A further 20 enterprises will be made ready for private sale to one or more investors, including foreigners. In addition, as an experimental approach, some 15 groups of enterprises will be privatized with a consulting firm or investment bank acting as a general coordinator.

24. To achieve large-scale privatization in a short time span, a strategy had been proposed to distribute free shares, in the form of privatization coupons,

in National Wealth Management Funds to adult Polish citizens (Bobinski, 1991). Although specific details have yet to be elaborated, the overall scheme is to create between 5 and 20 of such Funds, to be headed by Polish chairpersons and Polish Board representatives but to be operated by experienced Western managers from banks or investment funds. Equity in the 400 enterprises selected to be privatized in this fashion would be split three ways: 60 per cent would be transferred to the Management Fund, the State Treasury would retain a 30 per cent equity; and the remaining 10 per cent would be given to the employees of the particular enterprise. Trading in the Management Fund participation certificates - that is, shares - would be permitted, for both Polish citizens and foreigners, in early or mid 1993, after the companies held by the Funds had published their first full year's financial results.

25. The 400 or so enterprises selected for mass privatization play a significant role in the Polish economy, accounting for about 25 per cent of industrial sales and 12 per cent of employment. Because of the relatively short (three-year) period planned for completing the project, the Ministry of Ownership Transformations initiated various preparatory activities in the first half of 1991 so that implementation could get under way during the latter half of the year. These included (Monitor Polski, No. 43):

(a) Selecting the 100 enterprises considered to be the safest candidates for the first round;

(b) Preparing preliminary estimates for how successive privatization would be scheduled, while balancing the three main factors of the market, the State budget and the capital market;

(c) Defining the technical details and logistics of the bonus coupon scheme and how enterprise shares are to be allocated to the various National Wealth Management Funds;

(d) Mobilizing public opinion in favour of the concept of share ownership by the general public;

(e) Examining the potential for participation by Polish institutional investors such as banks, insurance companies and pension funds;

(f) Designing the conditions for creating and operating mutual funds with the participation of foreign capital and management, including defining their activities (such as issuing new shares, raising loans, and entering into various types of contracts) and how the funds are to be remunerated.

B. Small- and medium-sized enterprises

26. Although the Privatization Act was not passed until 13 July 1990, a considerable amount of small-scale privatization was carried out in advance. This was mainly effected through renting or leasing retail stores, owned by

the State, local governments, or cooperatives, under the provisions of the Business Premises Law of 10 April 1974, and by selling fixed assets (automotive equipment, in particular) under the State Enterprise Act of 26 September 1981. By the end of June 1990, some 12,000 of the 125,000 State and cooperative retail stores were being operated privately under rental or lease agreements. In the meantime, the State had sold off almost 500 retail stores, nearly 14,000 building sites, over 25,000 apartments, and various items of machinery and equipment (Baczynski, 1990).

27. The privatization tempo stepped up considerably after the political restructuring which occurred in June 1990. Newly constituted local governments were expected to live off their own resources, and thus were not provided with any start-up funding to cover their new financial responsibilities, which included, among other things, paying for local education and various public services. Almost immediately, local governments around the country started unilaterally terminating property rental agreements and started negotiating with the highest bidders. By the end of October 1990, some 50,000 retail units had changed into private hands. About 80 per cent of the retail trade was expected to be privatized by the middle of 1991, with complete privatization by the end of the year (Monitor Polski, No. 43).

28. Some 5,500 State enterprises fall into the categories of small and medium-sized: 2,500 are industrial enterprises, and about 3,000 are in other branches of the economy such as construction, transportation, trade, and tourism. The privatization techniques selected generally depend on the operating profile of the particular enterprise and the size of the market affected. While the transformation process has been more generally identified with large enterprises, commercialization - that is, liquidation - is planned to be used intensively, particularly for medium- and small-sized enterprises. It is anticipated that as many as 1,000 enterprises could be privatized in this way in 1991.

III. IMPLEMENTING THE PRIVATIZATION PROCESS

A. The Privatization Act

29. The Privatization Act of 13 July 1990 (Monitor Polski, No. 43) provides two main methods for transferring State enterprises into the private domain: transformation, and liquidation, also known as commercialization. Under the transformation approach, an enterprise is legally transformed into a private company subject to the Commercial Code with the State Treasury as sole shareholder. The State can then decide which of several options, individually or in combination, it will use to put some or all of its shares into private hands. These options include trade sale, public offer and management/employee buyout. Under the liquidation approach, the enterprise is liquidated in order to carry out certain planned privatization methods. These could include a sale or rental of the assets, a management/employee buyout, or the formation of a new company with domestic or foreign private participation with the State Treasury.

30. Shares may be sold in three ways: by auction, through a public offering, or by negotiation following a public invitation, unless the Council of Ministers approves some different method. The Minister for Ownership Transformations, with the approval of the Minister of Finance, specifies the financing principles for the sale of State-owned shares. Possible options are payment on the instalment basis (for Polish citizens) and payment with securities and/or cash. Restrictions are placed on direct or indirect ownership by foreigners. Offering shares whose par value exceeds 10 per cent of the share capital or offering privileged (preferred) shares to foreign parties or to legal entities or persons registered in Poland who are directly or indirectly controlled by a foreign party requires the approval of the president of the Foreign Investment Agency. These same restrictions apply should the Minister for Ownership Transformations decide to increase the share capital of a company owned exclusively by the State Treasury through an issue of new shares.

31. Employees of a transformed enterprise are entitled to buy up to 20 per cent of the total amount of the company's shares on a preferential basis. This privilege extends for a period of one year from the date that shares are made available for sale to employees. Employees may also acquire shares on the same terms as those available to non-employees. The preferential price of shares to employees during the entire one-year entitlement period is 50 per cent of the price set on the first day of sale for Polish citizens. The total value of the preferential discounts given to employees may not, however, exceed a certain monetary amount.

32. An innovative feature in the Act is the contemplated issuance of privatization coupons, free of charge and in equal amounts, to all Polish citizens resident in Poland. The coupons could be used in various ways to acquire State property - for example, to pay for shares issued by companies, to acquire an interest in mutual investment funds holding shares issued by companies, or to acquire enterprises or integrated parts of their assets, privatized through the liquidation approach.

B. Two models of privatization 4/

33. Because privatization can be implemented in various ways in Poland, attention is focused on the two approaches which attempt to incorporate socio-political goals into economic ones - namely, the management/employee buyout, and the public share offering.

1. The management/employee buyout

34. The Inowroclaw Meat Processing Plant was the first State enterprise to be privatized by means of a management/employee buyout. The privatization initiative came from the employees who, knowing that the enterprise was in good financial condition and operating profitably, wanted to take advantage of securing ownership for themselves while the opportunity existed. Another

deciding motive was the opportunity for pay increases, because under private ownership the company would not be subject to a tax on above-standard wages.

35. In June 1990, an application was submitted to the chief administrative officer of Bydgoszcz, where Inowroclaw is located, for privatization. Three months later, on 27 September, the Inowroclaw plant became one of the first seven enterprises to be transformed into a private company, solely owned by the State Treasury. While the other six were transformed into public corporations (spólka akcyjna = SA), the plant became a limited liability company (spólka z ogranicza odpowiedzialnościa = Sp.z o.o.). The State's next step was to place a value on the company.

36. At first, expert consultants, acting for the State Treasury, concentrated their attention on the financial condition, and preliminary figures of between 37 billion and 41 billion zlotys (then about $3.9-4.3 million) were provided. After the consulting firm had inspected the physical plant, including some buildings that were over 100 years old, the final amount arrived at was 30 billion zlotys (about $3.16 million). This was about six times the recorded book value of the property, and only the experts knew how it was calculated.

37. The accounting significance of the valuation question is the fact that, in some countries, property, plant and equipment are valued at historical cost. In periods of rising prices and where technical obsolescence is not a major issue, historical book value can be less than replacement cost. In Poland, on the other hand, revaluations of fixed assets have been required by the Government from time to time. The average revaluation of fixed assets taking effect on 1 January 1990 was 1,100 per cent, while the average rate which went into effect on 1 January 1991 was 260 per cent. It is conceivable, then, that the book value of the Inowroclaw plant's fixed assets could have been higher than replacement cost, because of the arbitrary nature of the period revaluations.

38. A second valuation issue is the way in which the enterprise is privatized. The privatization of Inowroclaw by transformation might have been more advantageous to the State Treasury, because it could command a "going-concern" price. Because of relatively small total capital and the purchase by one group - the workforce - the employees argued in favour of the liquidation approach which, by that time, was legally available.

39. The purchase agreement provided that 20 per cent of the total purchase price - that is, 6 billion zlotys - would be allocated to share capital. This represented 4,000 ordinary shares and 1,000 preference shares, carrying a 50 per cent discount, for a total of 5.4 billion zlotys in cash as a down payment. The remaining 24 billion zlotys was borrowed from the State Treasury through a five-year loan, secured by a mortgage on the fixed assets. The initial annual interest rate on the loan was 34 per cent. Within a month, the interest rate increased to 43 per cent, and by December it had climbed to 55 per cent. The average pay for a member of the workforce was about 800,000 zlotys, or just over $80 per month. So, the cost of one share, at

1.2 million zlotys, represented about six week's gross earnings, and most new shareholders went heavily into debt in order to invest.

40. One of the lessons to be drawn from this experience is that if the management/employee buyout technique is to be used to meet the socio-political goal of engaging the workforce in the economic process, then the financial terms have to be compatible with the circumstances in which the management and employees have to operate.

2. The public share offering

41. Privatization in Poland through public share offerings started in March 1990 when questionnaires were sent to State enterprises whose financial and economic data appeared promising. Talks were also held with management personnel, workers' councils, and potential domestic and foreign investors. As a result of these preliminary activities, 195 enterprises submitted information which went into the data bank at the Ministry for Ownership Transformations (Monitor Polski, No. 43, poz. 333, 2.1). The data was sorted according to various criteria - the three most important being interest to investors, support at the enterprise level for a privatization initiative, and lack of problems connected with legal ownership of the enterprise. By the end of October 1990, 20 enterprises had been transformed, and nine others were scheduled to be transformed.

42. The first public offering of shares took place on 30 November 1990. Details of the five companies and their capitalizations appear in table 1. The preparatory activities of the Ministry for Ownership Transformations included an extensive advertising and publicity campaign. The total issue price of all shares offered for sale was about 377 billion zlotys, or about $39.5 million. The estimated costs related to the public subscription, preparatory work on opening a stock exchange, and payment to consulting firms for their economic and financial analyses were between 4 and 5 per cent of the total offer price (Monitor Polski, No. 43, poz. 333, 2.1).

43. Share sales got off to a very slow start, and the subscription period had to be extended beyond the original deadline. This situation can be attributed to two main factors: the inadequacy of the banking system which served as a substitute for a securities exchange, and the general unfamiliarity of potential investors with a public share offering. Problems of introducing new investors to the world of finance were aggravated by accounting-related problems. In essence, almost no professional guidance was available concerning the potential risks and rewards of investing in any of the newly constituted SAs. Very elaborate prospectuses, prepared by Western consultants using unfamiliar formats for the balance sheets and income statements, proved more baffling than illuminating.

44. For some, reliance on rumour, intuition, or loyalty to the firm proved successful - that is, if they invested in Exbud, an early heavy favourite, or in the cable company SFK. As detailed in table 2, one of the SAs, the

Table 1. The first five large enterprises privatized through a public share offering

Name, activity and registration date	Capitalization	Number of shares offered	Nominal value per share (zlotys)	Issue price (zlotys)
Exbud S.A. Kielce (Construction company) 28 September 1990	1 million	450 000 (45%)	50 000	112 000
Slaska Fabryka Kabli, S.A. Czechowice-Dziedzice (Cable factory) 5 October 1990	1 million	830 000 (83%)	50 000	70 000
Krosnienskie Huty Szkla (KHS) Krosno, S.A. Krosno (Glass works) 15 October 1990	2.2 million	1.1 million (50%)	50 000	65 000
Próchnik, S.A. Lodz (Clothing manufacturer) 1 October 1990	1.5 million	1.2 million (80%)	50 000	50 000
Tonsil, S.A. Wrzesnia (Audio equipment manufacturer) 8 October 1990	1.5 million	750 000 (50%)	40 000	80 000

Source: Published prospectus for each company.

Table 2. Issue prices, price/earnings and price/book value ratios, and subsequent quoted prices for the first five large enterprises privatized through a public share offering

		Exbud	SFK	Krosno	Próchnik	Tonsil
1.	Book value a/ (millions of zlotys)	163 762	64 846	208 681	68 305	77 901
2.	Number of shares (millions)	1	1	2.2	1.5	1.5
3.	Book value per share (1 ÷ 2)	163 762	64 846	94 855	45 537	51 194
4.	Net income for 1990, annualized (millions of zlotys)	137 881	58 584	89 022	31 883	36 000
5.	Earnings per share (4 ÷ 2)	137 881	58 584	40 464	21 255	24 000
6.	Issue price per share	112 000	70 000	65 000	50 000	80 000
7.	Price/earnings ratio (6 ÷ 5)	0.8	1.2	1.6	2.4	3.3
8.	Price/book value ratio (6 ÷ 3)	0.68	1.08	.069	1.10	1.54
9.	Share price b/	196 000	80 000	56 500	41 500	56 000
10.	Price b/ as percentage of issue price (9 ÷ 6)	175	114	87	83	70

Source: Compiled from data contained in the published prospectus for each company (for items 1-8); Rzeczpospolita, 29-30 May 1991 (for item 9).

a/ Shareholders' equity.

b/ Quoted on 28 May 1991.

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price/earnings ratio of Exbud was the lowest of all five companies, and its shares have been in heaviest demand since the Stock Exchange opened in April 1991. Employees who bought shares at a 50 per cent discount in Exbud have had a happier experience than investors in Krosno, Próchnik and Tonsil, companies which are experiencing financial difficulties.

C. Difficulties in implementing privatization

45. The twin factors of political instability and critical economic conditions have left their mark in the slow rate of implementation of large and medium-sized enterprise privatization in Poland. If just one concern could be selected as characteristic of the current situation, it would be uncertainty.

46. Some two years have elapsed without a firm enunciation of industrial policy. So, with no clear notion of how or when their enterprises are to be privatized, managers are taking very short-run stances. As a recent study shows (Kotowicz, 1991), there are very few research and development programmes under way to adapt technologies in the country's failing industries so as to try and improve the economic picture. The fact that Western managers are being sought for large enterprises scheduled for transformation is yet another factor working against the motivation of Poland's professional managers.

47. As the economic recession deepens, the Government has increased problems by putting the best candidates forward first. It was almost six months before the next large enterprise, the Swarzedzkie Fabryki Mebli (Swarzędz Furniture Factories: SFM), was put on the market, because it first had to be restructured. The management was decentralized and production reorganized into differentiated plants specializing in the production of particular types of furniture. In addition, the State Treasury relieved SFM's balance sheet of a 64-billion-zloty debt (about $6.7 million). This meant that the company, transformed as Swarzędza SA, would be freed from the heavy burden of interest on the debt. This time, investor interest was very heavy, and small investors snapped up the allotted 900,000 shares, at 50,000 zlotys each, in the first 40 minutes that they were on sale. The State Treasury expected to realize a total of 70 billion zlotys on the offering, which it would keep for itself - earmarking 64 billion for repayment of the company's debt. It was then announced that a further 500,000 shares would be issued because of the excess demand and that this time the company would be permitted to keep the proceeds.

48. Several factors contributed to the success of this sixth offering. The company was very well known for its excellent furniture, most of which was exported for hard currency. Stock subscription arrangements were much better organized, and investors also knew that they would be able to trade their shares on the newly opened Securities Exchange. Thirdly, Exbud's success on the Securities Exchange created a market for potential investors. The Government could, therefore, congratulate itself on the outcome of the seven months of effort that it had put into the restructuring.

IV. IMPLICATIONS OF PRIVATIZATION FOR ACCOUNTING

49. There are three main types of accounting-related problems which have arisen during Poland's transition to a market economy. First, there are the difficulties of a fairly universal nature connected with valuation and pricing; these seem to take precedence in terms of concern. Then, there are the problems connected with shifting from fund accounting to commercial accounting. Thirdly, there are problems with the concept of internal and external financial control associated with the audit function.

A. Use of commercial accounting systems by State enterprises

50. In order to appreciate the problem of valuation, one has to understand the general structure of the accounting systems involved. In common with most of its post-socialist neighbours, Poland's State enterprises have used standardized charts of accounts for particular economic or industrial sectors, with double-entry bookkeeping. Using a fund approach, groups of assets (aktywa) on the balance sheet are identified with the sources of those assets (pasywa). This is the "cycle of activity" approach which underlies the general model of a Western audit. So, in a certain sense, the fund-based, integrated balance sheet could be viewed as having a more sophisticated structure than the typical corporate model in the United States and the European Community.

51. Until the new accounting law came into force on 1 January 1991, Poland used certain accounting practices which would not be considered generally acceptable. Fixed assets were periodically revalued, and earlier values were replaced in such a manner as to lose the audit trail. Also, the nature of the political/economic system had an impact on the valuation of current assets. Receivables, valued in the West at net realizable amounts, would be reversed against sales if payment were not made by 25 January of the following year. The lower of cost or market as a basis for valuing inventories was not an accepted accounting principle, because material prices were State-controlled. Land appeared on the balance sheet only if it had been purchased by the enterprise, which was legally possible in Poland. Depreciation was recorded using straight-line methods defined by the State.

52. The differences between Poland's accounting principles and those practised in the European Community have been largely eliminated in the new acccunting law. One significant factor in the law is, however, the lack of provision for inflation accounting, for Poland is now experiencing once again a sharp return to increasing price levels.

53. A major problem that Poland faces in implementing the new law is the training of its existing accounting and finance personnel. The Association of Accountants, with assistance from various sources, has been involved in a retraining process. This has largely taken the form of training classes for accounting instructors and special topic workshops for those employed in the

accounting and finance functions. Since all are very well acquainted with double-entry bookkeeping, one of the main areas of emphasis should be on the form and construction of the main financial statements, evaluation of financial condition, and other aspects connected with the financial management of a private company organized for profit.

B. Accounting and valuation processes

54. The extent to which accounting information may be used in the privatization process depends on the particular privatization technique involved. If an enterprise is to be privatized as a going concern, the use of a net discounted cash flow approach would probably be the preferred method. For various reasons, this technique is difficult to apply in Poland and other post-socialist countries for several reasons. Past profitability may be difficult to assess because of the widespread use of State-controlled prices and differences in accounting principles. Also, because the privatized unit will be operating in a very different environment - at least politically, if not economically - past history may not be a reliable guide to future prospects. Further, the discount rate may be extremely difficult to set in view of swings in interest rates and the perceived high level of risk. For all of these reasons, the use of some multiple of book value may also be questionable, although it benefits from being easily understood (except for how the multiple was selected) and it is widely acceptable to those who assume that book values approximate "real" values.

55. Book values in Poland, as elsewhere, may not faithfully represent past transactions, because some events may not have been recorded. This is a particular problem with respect to undisclosed liabilities for pensions, repair of environmental damage, and other issues which could have a significant financial impact. Because financial reporting has been an internal exercise, not subject to external review, certain accountability issues have not arisen in the past. Here, particular emphasis is on the concept of "substance over form", under which Western accounting practices follow the nature of a particular transaction rather than its legal form or structure. For example: leases which are, in substance, purchase agreements are usually capitalized under generally accepted accounting principles. Renting and leasing agreements have only lately assumed importance in Poland.

C. Presentation of accounting information in privatization

56. A number of problems connected with accounting and valuation processes may be better appreciated by reviewing certain aspects of the five privatization schemes carried out by transformation and public share offerings in November and December 1990.

1. Presentation of financial information

57. A review of the prospectuses leads one to concur with certain Polish observers (Czekaj, 1990) that Western-style presentation of data is not, at the present time, well adapted to the needs of new investors for information about the financial history, risks and prospects associated with privatized enterprises. This is because very little light is shed on the way in which inflation affects trends analysis; financial-statement format is largely unfamiliar; and the calculation of financial indicators is difficult and their use possibly misleading. This is because the underlying data was prepared in accordance with previous accounting laws not congruent with generally accepted accounting principles in market economies.

58. For example, financial data were presented in some detail for each of the three years 1987, 1988, and 1989, plus the partial year 1990 (the first six months for SFK, Krosno and Tonsil; the first eight months for Exbud; the first nine months for Próchnik). For each company, comparative inflation-adjusted sales figures were provided based on purchasing power at the date of the 1990 balance sheet. This enabled the user to calculate the magnitudes of the purchasing power adjustments and trace the sales trends, as shown in table 3.

59. Annualizing the partial 1990 sales data facilitated the analysis of sales trends. It shows that, in comparison with 1989, 1990 sales for Exbud and Tonsil were at about the same level, while 1990 sales for the other three companies were running about one third less than in the prior year. The magnitude of the purchasing power adjustments testifies to the hyperinflationary conditions. Intercompany differences in these magnitudes within the same years can be attributed to such factors as the choice of indexes or application methods, the composition of the sales, and whether the transactions were denominated in domestic or foreign currencies.

60. None of the companies described application methods, and only three of them identified their points of reference for inflation adjustments. Exbud referred to industrial price increases; Próchnik, a clothing manufacturer, stated that it used inflation statistics for the clothing industry supplied by the Chief Statistical Office; and SFK disclosed that it used internally generated price inflation indexes. Because there was no way to calculate the effects of inflation on other key amounts, such as cost of sales and net income, the value of presenting unadjusted prior years' data for purposes of assessing prior years' performance is questionable.

Table 3. Comparison of constant prices and current prices for 1987, 1988, 1989, and 1990 for the first five large enterprises privatized through a public share offering

	Exbud	SFK	Krosno	Próchnik	Tonsil
1987					
Constant price	345 087	424 485	552 116	219 778	228 568
Current price	11 467	6 793	12 511	7 092	8 109
Magnitude of adjustment	30.09	62.49	44.13	30.99	28.19
1988					
Constant price	413 839	436 964	689 801	233 871	258 739
Current price	21 974	13 773	21 740	11 344	14 231
Magnitude of adjustment	18.33	31.73	31.73	20.62	18.18
1989					
Constant price	743 502	430 503	848 127	226 542	268 578
Current price	130 426	42 776	67 355	36 444	50 517
Magnitude of adjustment	5.70	10.06	12.59	6.22	5.32
1990 a/					
Constant price	535 848	143 596	286 661	103 871	133 918
Current price	509 227	143 596	221 321	103 871	127 739
Magnitude of adjustment	1.05	1.00	1.30	1.00	1.05
Sales at constant prices, annualized	803 772	287 192	573 322	138 495	267 836
Annualized sales as percentage of 1989 sales (constant prices)	108.0	66.7	67.6	61.6	99.7

a/ For SFK, Krosno and Tonsil: 6 months of data; for Exbud, 8 months; Próchnik, 9 months.

/...

2. Inflation and revaluation effects

61. The effects of inflation on balance sheet items, on the other hand, is to some extent reflected in the book values (that is, amounts net of depreciation) of fixed assets. In Poland, all State enterprises are periodically required to revalue fixed assets, using uniform percentage rate increases depending on the particular asset category or group. Depreciation on revaluation increases is calculated, and accounted for, in the same way as depreciation on historical cost. In most Western countries, fixed assets are accounted for at their historical cost, and revaluation is not a generally accepted accounting principle. There have been, as mentioned above, two recent revaluations in Poland. As shown in table 4, revaluations had the greatest impact on the net book values of fixed assets for Krosno and Próchnik.

62. Despite the hyperinflationary conditions, Poland's new accounting law, which went into effect on 1 January 1991 (Dziennik Ustaw No. 10, poz. 35), does not contain any provisions for inflation accounting. Subsequent legislation passed on 29 July 1991 (Dziennik Ustaw No. 71, poz. 308), governing the prospectus for an issue of securities to the public, contains only one reference to inflation-adjusted financial information (para. 11.7):

> If the last three years of the issuer's activities fell in a period of large-scale inflation (higher than an annual rate of 20 per cent), the financial data (at least with respect to sales value) should be adjusted by an inflation index with disclosure of the source of the index and method of application.

63. This clause formalizes the practices which were followed in the prospectuses for the five companies privatized in December 1990. That is, only the minimum data, the sales figures, were inflation-adjusted. The above paragraph, however, fails to take into account the recommendations of the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting. 5/ In view of the distortions of financial condition and financial results reported on a historical cost basis under inflationary or hyperinflationary conditions, the new regulations governing financial reporting appear to require amendment.

64. The potential investor is, of course, interested in which of the offered stocks would be a "best buy" - that is, which have the best potential for generating future income so as to offer opportunities for dividends and profit on resale of shares.

Table 4. Effects of revaluations on the net fixed assets of the first five large enterprises privatized through a public share offering

(Millions of zlotys)

Company	Partial period ended	Net book value of fixed assets	Revaluation amounts included in net book value	Revaluation as a percentage of net book value
Exbud	31 August 1990	71 659	21 808	30
SFK	30 June 1990	27 199	12 217	45
Krosno	30 June 1990	134 364	126 610	94
Próchnik	30 September 1990	27 857	23 930	86
Tonsil	30 June 1990	65 383	41 947	64

Source: Compiled from data in the prospectus for each company.

3. Evaluation of share offer prices

65. As has been shown above, few of the historical, statistical data provided are useful for the potential investor. The comparative data for prior years which are used in the West for trend analysis are not adjusted for the effects of inflation. Further, a critical assumption when incorporating historical data into the future-oriented decision process is that the past provides a reasonable basis for predicting the future. This does not hold in the Polish case, because a company newly formed out of a State enterprise will be operating in a completely different environment. This situation was pointed out in the prospectuses in narrative descriptions of the various risks the enterprises face. Since this qualitative information is not quantified, the investor has to rely heavily on intuition or luck. However, it would be helpful to know how the shares were priced. This is not disclosed anywhere. One can, however, evaluate the offered prices using two widely used statistics: the price/earnings ratio, and the ratio of offer price to book value. These were calculated in table 2, using annualized income for 1990 to calculate the price/earnings ratio.

66. The price/earnings ratio is calculated by dividing the offer price per share by earnings per share. It shows how many years of earnings an investor is paying for when buying a share. The lower a firm's potential for growth, the lower the ratio. So, a well-established company without expectation of

significant increases in annual earnings per share, for example, will not command a high price/earnings ratio. Companies with high potential for increased earnings will, all other things being equal, command a higher price/earnings ratio. In 1988, the price/earnings ratio for the Ford Motor Company was 5. Investors will be willing to pay for more years of current earnings on the assumption that the value of their purchased shares will rise as the company becomes more profitable. So, several factors affect differences between the price/earnings ratios of different companies. They include the trends in, and stability of, a company's earnings, relative risks, and perceived growth potential.

67. The price/earnings ratios for the large five companies privatized in Poland were very low indeed, even though the ratios are understated, because annualized earnings may have overstated the 1990 income. For Exbud, for example, the offer price was only just over 80 per cent of the 1990 earnings on an annualized basis. Under Western standards, and all other things being equal, the stock is very much underpriced or its future prospects are very poor. The Próchnik and Tonsil shares were the only ones requiring investors to pay for more than two years' earnings.

68. The book value per share is calculated by dividing the shareholders' equity, or "own capital", as expressed in Poland, by the number of common shares outstanding. The book value is most relevant when the net assets (that is, total assets minus total liabilities) are shown on the balance sheet at or near their market values. The book value per share would then indicate the amount that shareholders would expect to receive if the company were liquidated in the near future. In countries where balance sheets show historical costs, market values would probably be higher than book values in periods of rising prices. As pointed out above, the Polish revaluations of fixed assets have probably resulted in some correction for the effects of inflation on balance-sheet items.

69. Some financial analysts will recommend shares with market prices lower than book values as "good buys", particularly if book values reflect market values and there is either a short-run perspective or the prospect of the company breaking up, for example. One could expect market values to exceed book values in the long run, since the intangible asset of earning power (goodwill) is not booked unless purchased. From this standpoint, Exbud and Krosno, with offering prices of 68 and 69 per cent, respectively, of their book values, are "best buys". Kabel (SFK) and Próchnik are just about at par, with Tonsil at about one and one-half times book value. (These statistics can only add to the bitterness at Inowroclaw where the employees were charged six times book value for their shares.)

Notes

1/ The dividend is, in essence, a charge for the use of State-provided property. It is calculated at 32 per cent per year of the book value of certain fixed assets, contributed by the enterprise's founding body, as of the end of 1983. Because of the major, and arbitrary, revaluations carried out in 1989 and 1990, the amount of the dividend increased significantly. It is payable monthly, regardless of financial results.

2/ Commercial Code, 27 June 1934; Act Relating to Economic Activities of Foreign Entities, 14 June 1991; Banking Act of 31 January 1989; and Act of Privatization of State-owned Enterprises, 13 July 1990.

3/ This section is drawn from Tarnowski (1991) and Zukowska (1991).

4/ This section is drawn from Niedosug (1990) and Tarnowski (1990).

5/ "Accounting for inflation and changing prices and market and historical values of assets and liabilities", International Accounting and Reporting Issues: 1989 Review (United Nations publication, Sales No. E.90.II.A.4).

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